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Supreme Court U.S.
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In the Supreme Court of the United States

WINN-DIXIE STORES, INC. AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY TO BRIEF IN OPPOSITION

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16pp

TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES ii

REPLY TO BRIEF IN OPPOSITION 1

TABLE OF AUTHORITIES

CASES

Bob Jones University v. United States,
461 U.S. 574 (1983) 7

Brown v. Gardner,
513 U.S. 115 (1994) 7

Compaq v. Commissioner,
No. 00-60648, 2001 WL 1662035
(5th Cir. Dec. 28, 2001) 3

Fabreeka Products v. Commissioner,
294 F.2d 876 (1st Cir. 1961) 4

Frank Lyon Co. v. United States,
435 U.S. 561 (1978) 1, 2, 4

Gregory v. Helvering,
293 U.S. 465 (1935) 1

Horn v. Commissioner,
968 F.2d 1229 (D.C. Cir. 1992) 5, 7, 8

In re CM Holdings, Inc., 254 B.R. 578 (D. Del. 2000),
appeal pending, No. 00-3875 (3d Cir.) 8

Knetsch v. United States,
364 U.S. 361 (1960) 1, 5, 6, 8

Maysteel Products v. Commissioner,
287 F.2d 429 (7th Cir. 1961) 4

N. Indiana Public Service Co. v. Commissioner,
115 F.3d 506 (7th Cir. 1997) 3

Pension Benefit Guaranty Corp. v. LTV Corp.,
496 U.S. 633 (1990) 9

Public Employees Ret. Sys. of Ohio v. Betts,
492 U.S. 158 (1989) 9

Sacks v. Commissioner,
69 F.3d 982 (9th Cir. 1995) 4

UPS v. Commissioner,
254 F.3d 1014 (11th Cir. 2001) 10

Yosha v. Commissioner,
861 F.2d 494 (7th Cir. 1988) 3

STATUTES

Health Insurance Portability & Accountability Act of
1996, Pub. L. No. 104-191, 110 Stat. 1936 (1996) 9

I.R.C. § 163(a) (West 1993) 5, 6, 8

I.R.C. § 165(c)(2) (West 1993) 6

I.R.C. § 183(a) (West 1993) 6

I.R.C. § 195(c)(1)(A)(iii) (West 1993) 6-7

I.R.C. § 212 (West 1993) 7

I.R.C. § 264 (West 1993) 5, 8

I.R.C. § 7702 (West 1993) 5

LEGISLATIVE MATERIALS

H.R. Conf. Rep. No. 104-736, at 322 (1996) 9

OTHER AUTHORITY

Compaq v. Commissioner, No. 00-60648, Petition for Reconsideration (5th Cir. filed Feb. 2002) 3

Dep't of Treas., The Problem of Corporate Tax Shelters (July 1999) 10

REPLY TO BRIEF IN OPPOSITION

The Commissioner's Brief In Opposition fails to engage the real issues in this case, and illustrates the confusion and incoherence that plague the so-called "sham transaction doctrine" in the lower courts.

1. The Commissioner's brief seeks to obscure the legal issues in this case by characterizing the Eleventh Circuit's holding as a "factual determination" that the disputed COLI policies "had no economic function other than generating tax deductions." Opp. 9, 12, 19. That portrayal is incorrect.

First, whether a particular transaction qualifies as a "sham" is indisputably a question of law, not fact.[1] This Court's decisions make clear that the ultimate issue in every sham transaction case is a question of statutory interpretation.[2] The Tax Court and the Eleventh Circuit correctly held that whether Winn-Dixie's COLI policies qualified as "shams" was a question of law. App. 3a, 40a-43a.

Second, the Commissioner's repeated and conclusory assertion that Winn-Dixie's COLI policies were shams because they "had no economic function other than generating tax deductions" is a transparent attempt to gloss over the Eleventh Circuit's actual holding and the inter-Circuit conflicts that holding creates. The IRS and the courts below did not (and could not) conclude that the COLI policies had no genuine economic effects on Winn-Dixie, or were somehow illusory or offsetting. That is the sham transaction test applied by this Court in *Knetsch* and *Frank Lyon*, and by

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[1] *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978) ("The general characterization of a transaction for tax purposes is a question of law subject to [de novo] review.").

[2] *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("whether what was done, apart from the tax motive, was the thing which the statute intended."); *Knetsch v. United States*, 364 U.S. 361, 365 (1960) (same).

(at least) the First, Seventh, and Ninth Circuits in subsequent cases. *See* Pet. 21-26. There can be no doubt that Winn-Dixie would have prevailed had that test been applied here. The COLI policies had enormous nontax economic consequences for Winn-Dixie and AIG, genuinely shifting substantial risks and obligations on both sides. The Petition summarizes some of those risks and obligations; they included, for example, potential death benefits payable from AIG to Winn-Dixie in year four of more than $3 billion (exceeding the disputed policy loans by a ratio of more than ten to one). Pet. 26-28.[3]

Winn-Dixie lost because the Tax Court and the Eleventh Circuit instead accepted the IRS's view that a transaction lacks "economic substance"—even if it has real, nontax economic consequences and shifts real risks—whenever the transaction is not "likely" to produce a "pretax profit." As the Petition demonstrated, this pretax profit requirement is in direct conflict with this Court's precedents and the decisions of at least three other Courts of Appeals. *See* Pet. 21-28. It simply reflects the IRS's apparent conviction, repeatedly rejected by this Court, that it is somehow illegitimate for taxpayers to consider tax consequences when making business decisions.[4] In addition to being inherently irrelevant in a life insurance context, Pet. 26 n.16, the pretax profit

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[3] The Commissioner speculates with the Tax Court that it was "improbable" or "unrealistic" to believe that Winn-Dixie's death benefits could have diverged from actuarial predictions. As the Petition explains at page 27 n.17, that speculation is unsupported and legally irrelevant. In any event, Winn-Dixie's COLI policies had significant economic consequences not related to policy death benefits. *See* Pet. 26-28.

[4] *See, e.g., Frank Lyon*, 435 U.S. at 580 ("The fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.").

requirement is also incoherently circular (because efficient capital markets already take tax consequences into account when setting prices), and nullifies incentive provisions in the Code (because it forbids taxpayers from considering tax incentives when deciding whether to make a particular investment). *See* Pet. 25-26 & n.16.[5]

Perhaps lacking anything persuasive to say on this issue, the Commissioner's brief pretends that the issue does not exist. Its sole response to Winn-Dixie's demonstration that the COLI policies had extensive real-world economic effects and genuinely shifted numerous risks and obligations (Pet. 26-28) is a footnote speculating that if the COLI policies had "meaningful non-tax economic benefits" then Winn-Dixie would not have unwound them after Congress changed the tax treatment in 1996. Opp. 16 n.7. But of course Winn-Dixie's point was that the Commissioner's pervasive conflation of economic substance with "non-tax economic benefits" (*i.e.*, pretax profitability) is contrary to law. A true sham transaction is illusory because it involves no "actual, non-tax-related changes in economic position," *N. Ind. Pub. Serv. Co. v. Comm'r*, 115 F.3d 506, 512 (7th Cir. 1997), and therefore entails "zero risk of gain or loss," *Yosha v. Comm'r*, 861 F.2d 494, 501 (7th Cir. 1988). The distinction between that test and

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[5] Winn-Dixie's COLI policies were in fact profitable on a pretax basis, correctly conceived. The Tax Court's contrary conclusion stems from its refusal to acknowledge that the death benefits and inside buildup received by Winn-Dixie were indisputably tax free (*i.e.*, post-tax) numbers, and should therefore have been grossed up in any true pre-tax calculation. *See* Pet. 5-6, 25 n.15. The Fifth Circuit recently confronted a similar issue and held that the Commissioner's "pre-tax profit" analysis unfairly stacked the deck against taxpayers. *Compaq v. Comm'r*, No. 00-60648, 2001 WL 1662035, at *6 (5th Cir. Dec. 28, 2001). The Commissioner conveniently ignores the issue here, but recently filed a petition for rehearing in *Compaq* citing this case as evidence of a conflict. *See Compaq v. Comm'r*, No. 00-60648, Petition for Reconsideration 12 n.5 (5th Cir. filed Feb. 2002).

the Commissioner's "pretax profit" requirement is well-developed in the cases, and has been the focus of this case.

The Commissioner's discussion of *Maysteel Products v. Comm'r*, 287 F.2d 429 (7th Cir. 1961), *Fabreeka Products v. Comm'r*, 294 F.2d 876 (1st Cir. 1961), and *Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995), similarly ignores the point. The Commissioner attempts to distinguish those cases on the ground that they involved transactions with "non-tax economic significance" or "practical economic effects." Opp. 17-18. But the same certainly is true of Winn-Dixie's COLI policies. The Commissioner did not attack the transactions in *Maysteel*, *Fabreeka*, and *Sacks* on the ground that they lacked "non-tax economic significance" or "practical economic effects"; there, as here, the Commissioner complained instead that the transactions were not likely to be profitable on a pretax basis. The First, Seventh and Ninth Circuits held that the transactions could not be "shammed" on that ground alone; the Eleventh Circuit in this case held just the opposite.

By the same token, the Commissioner argues that this Court's opinion in *Frank Lyon* is consistent with the Eleventh Circuit's decision in this case because *Frank Lyon* left open the possibility that "dealings that have no economic significance" can be disregarded as shams. Opp. 17 (quoting *Frank Lyon*, 435 U.S. at 583). But even a cursory reading of *Frank Lyon* reveals that this Court did not believe a transaction must be likely to produce a pretax profit in order to have "economic significance" and be worthy of respect. The Commissioner disregarded Lyon's claim to ownership of a building, largely because a purchase option held by another party precluded Lyons from benefiting from any upside appreciation. This Court refused to accept the Commissioner's "sham" characterization because Lyons retained "significant and genuine attributes of the traditional lessor status" and assumed "real and substantial risk[s]" associated with ownership. *Frank Lyon*, 435 U.S. at 584, 577.

Winn-Dixie's COLI policies similarly bore all of the hallmarks of a conventional insurance arrangement and entailed numerous "real and substantial risk[s]" for Winn-Dixie.

2. The principles of statutory interpretation advanced by the Commissioner are not consistent with this Court's precedents or with the D.C. Circuit's opinion in *Horn v. Comm'r*, 968 F.2d 1229 (D.C. Cir. 1992).

The Commissioner argues that "sham transactions" do not give rise to "indebtedness" for purposes of I.R.C. § 163(a) at all, and that Winn-Dixie's compliance with the Code's elaborate provisions specifically governing the deductibility of life insurance policy loan interest (such as I.R.C. §§ 264 and 7702) is therefore irrelevant. The Commissioner is correct that a taxpayer is not entitled to an interest deduction under § 163(a) if the transaction does not produce any genuine "indebtedness" at all.[6] He is also correct that this Court confronted precisely that situation in *Knetsch*. The district court in *Knetsch* found as a fact that "no indebtedness of [Knetsch] was created by any of the . . . transactions." *Knetsch*, 364 U.S. at 364. This Court accepted that finding and explained that the purported transactions were so offsetting and illusory that they never in fact happened—that the bonds on which Knetsch claimed an interest deduction were a "fiction," and the "loans" he received from the annuity company were "in reality only the rebate of a substantial part of the so-called 'interest' payments." *Id.* at 366. Those findings make it self-evident that no "indebtedness" existed at all, and that § 163 thus provided no deduction.

There are no such findings in this case. On the contrary, the Tax Court's opinion makes clear that "the transactional

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[6] The Commissioner's assertion that the Petition mischaracterized the government's position below on this point, see Opp. 10 n.2, rests solely on an inappropriate use of ellipses in the quotation, and has no merit.

events at issue in this case actually occurred," and that Winn-Dixie's policy loans from AIG were an "enforceable debt." App. 41a-42a. Instead, the Tax Court held: "The fact that an enforceable debt exists between the borrower and lender is not dispositive of whether interest arising from that debt is deductible under § 163. Rather, the overall transaction, of which the debt is a part, must have economic substance before interest can be deducted." *Id.* at 42a-43a. The Commissioner's theory (and that of the Tax Court and the Eleventh Circuit) is that, notwithstanding the plain and mandatory language of § 163(a),[7] a taxpayer is not entitled to deduct interest on an obligation that concededly qualifies as "indebtedness" under the plain meaning of that term *and for all other purposes at law and under the Code*, if that obligation was assumed in connection with a transaction the Commissioner believes would not have been profitable absent tax consequences and/or was not motivated by a nontax "business purpose."

That is obviously invention rather than interpretation, and it bears no resemblance to this Court's straightforward finding in *Knetsch* that no deduction was available because the "indebtedness" claimed by the taxpayer did not *in fact* exist.[8] The absurdity of the Commissioner's "interpretation" becomes even more apparent when § 163(a) is considered in its broader statutory context. The Code is replete with specific requirements that a transaction must be entered into "for profit" or for a "business purpose" in order to qualify for particular tax treatment. *See, e.g.*, I.R.C. §§ 165(c)(2), 183(a),

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[7] "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163(a).

[8] For this reason, the Commissioner simply begs the question of what constitutes a sham transaction by insisting that "the courts of appeals have consistently held that transactions that constitute economic shams do not create 'indebtedness' . . . under Section 163(a)." Opp. 11.

195(c)(1)(A)(iii), 212. It is improper, therefore, to read such requirements into a provision that conspicuously omitted them. *See, e.g., Brown v. Gardner*, 513 U.S. 115, 120 (1994). Section 163(k) also specifically cross-references § 264, which contains an elaborate and carefully balanced set of rules (including its own business purpose safe harbor, see § 264(c)(4)) specifically governing the deduction of interest on life insurance policy loans. Section 264 is self-evidently directed at specifying the kind and degree of nontax substance leveraged insurance arrangements must have in order to be respected for tax purposes, and the enactment and legislative history summarized in the Petition (Pet. 2-3, 12-14) demonstrate that Congress intended that provision to occupy the field.

It is of course true that § 264 does not itself grant deductions, but instead limits the deductions granted by § 163. But that does not mean—as the Commissioner would have it—that an elaborate set of extra-statutory limitations can or should be implied into § 163 without even considering whether those new exclusions will harmonize, duplicate, or conflict with the ones Congress put in § 264. As this Court noted in *Bob Jones University v. United States*, 461 U.S. 574, 586 (1983), "it is well settled that, in interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute . . . and the objects and policy of the law." The Tax Court's and Eleventh Circuit's refusal to test their sham analysis against that ordinary process of statutory interpretation is precisely the error condemned by the D.C. Circuit in *Horn*.[9]

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[9] The Commissioner's attempt to distinguish *Horn* on the ground that the Eleventh Circuit "did not hold the sham transaction doctrine applies independent of the Code," Opp. 15 n.6, is meritless. Whether the doctrine is

The Commissioner's brief makes two additional, yet similarly deficient, arguments. First, like the Eleventh Circuit, the Commissioner suggests *Knetsch* held that § 264 is irrelevant to the interpretation of § 163. As the Petition explained (Pet. 17-18), that is simply inaccurate. The taxpayer in *Knetsch* suggested that an absurd inference from subsequent congressional *inaction* retroactively authorized his deductions for interest on loans that this Court had already found to be wholly fictitious.[10] Winn-Dixie's argument is simply that the statutes actually in place in 1993, when read together fairly and in context, authorize the deductions it claimed. *Knetsch* does not (and could not, given its vintage) speak to that issue at all.[11]

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characterized as an extratextual overlay or (as the Commissioner now suggests) a completely atextual "interpretation" of the word "indebtedness" in § 163(a), the point is that the doctrine ignores the language and structure of the rest of the Code. In any event, the Commissioner attempted precisely the same maneuver in *Horn* by portraying the doctrine as an interpretation of the word "loss." The D.C. Circuit was not fooled. *See* 968 F.2d at 1239.

[10] Subsequent to the inception of the annuity, Congress prohibited all deductions in the kind of transaction that Knetsch's deal *purported to be*, but only prospectively. Knetsch argued that Congress's failure to make that exclusion retroactive impliedly blessed his deductions, even though—and this is critical—this Court had already found that Knetsch's purported transaction was in fact a "fiction." As this Court put it, Knetsch "would attribute to Congress a purpose to allow the deduction of pre-1954 payments under transactions of the kind carried on by Knetsch with the insurance company *without regard to whether the transactions created a true obligation to pay interest*." 364 U.S. at 367 (emphasis added).

[11] With the sole exception of *In re CM Holdings, Inc.*, 254 B.R. 578, 599-600 (D. Del. 2000), *appeal pending*, No. 00-3875 (3d Cir.), which involves a factually distinguishable COLI policy, the cases cited at Opp. 15-16 for the proposition that courts have "consistently rejected" arguments based on the text of § 264 all involved inferences similar to, or even less plausible than, the one rejected in *Knetsch*.

Second, the Commissioner maintains that the legislative history of the 1996 Act demonstrates congressional approval of the Commissioner's "sham transaction" overlay on §§ 163 and 264 for prior tax years. This is a misuse of legislative history; it is also completely unpersuasive. First, the Commissioner cites the legislative history of a *subsequently enacted statute* for guidance about the meaning of an earlier one. This Court has repeatedly cautioned that such material is of little or no value.[12] In any event, the same Conference Report emphasizes that "[n]o inference, [*sic*] is intended as to the treatment of interest paid or accrued under present law." H.R. Conf. Rep. No. 104-736, at 322 (1996). And the passages cited by the Commissioner simply recite empty platitudes (the transaction must "give[] rise to debt for Federal income tax purposes," and "generally applicable principles of tax law apply") that are as consistent with Winn-Dixie's theory as with the Commissioner's.

3. The Commissioner argues that this Court's review is not warranted on the role of subjective motivation in the sham inquiry, because Winn-Dixie cites no decision in which a transaction was held to have economic substance but was nonetheless condemned for lack of a subjective "business purpose." Yet the Eleventh Circuit has forthrightly and repeatedly announced its willingness to "sham" a transaction on that ground alone, and will do so in the instant case if this Court reverses that court's flawed economic substance holding. It is clear, therefore, that this case presents the opportunity to reach the issue.

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[12] *See, e.g., Pension Benefit Guar. Corp. v. LTV Corp*, 496 U.S. 633, 650 (1990) ("Subsequent legislative history is a hazardous basis for inferring the intent of an earlier Congress."); *Pub. Employees Ret. Sys. of Ohio v. Betts*, 492 U.S. 158, 168 (1989) ("[T]he interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute.").

More importantly, consideration of the taxpayer's subjective motivation often infects the "economic substance" prong of the sham inquiry as well. The Commissioner's brief illustrates the point quite well, by frequently arguing that Winn-Dixie's COLI policies lacked substance because Winn-Dixie was motivated by a desire to reduce its taxes. *Compare, e.g.*, Opp. 12 (deprecating Winn-Dixie's COLI program on the ground that it was "consciously designed" to produce tax benefits and lacked "credible evidence" of a "non-tax business purpose"), *with* Opp. 17 (distinguishing *Frank Lyon* on the ground that "diversification was Lyon's principal motivation"). The Commissioner merely compounds this confusion by citing *UPS v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001), for the proposition that "economic substance" and "business purpose" actually mean the same thing in the Eleventh Circuit, and that both exist whenever the transaction "figures in a bona fide, profit-seeking business." Opp. 19. Were that the law in the Eleventh Circuit, Winn-Dixie would have won this case and *UPS* itself would not have acknowledged a conflict with the Second, Fourth, and D.C. Circuits. *See UPS*, 254 F.3d at 1018 n.2.

The Commissioner's apparent confusion is not limited to this case. In a 1999 report to Congress, the Department of the Treasury conceded that "conflicting, incoherent decisions" under the sham transaction and other common law anti-avoidance doctrines "frustrate[]" the ability of taxpayers to predict or assess their own tax liabilities. Dep't of Treas., The Problem of Corporate Tax Shelters 99 (July 1999). "Because the application of these common law standards is inherently subjective and courts have applied them unevenly, a great deal of uncertainty exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions." *Id.* at 94. Winn-Dixie respectfully submits that the Department's observations are an eloquent argument for certiorari in this case.

Respectfully submitted,

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